

1 Jeff S. Westerman (SBN 94559)  
jwesterman@milberg.com  
2 **MILBERG LLP**  
One California Plaza  
3 300 S. Grand Avenue, Suite 3900  
Los Angeles, CA 90071  
4 Telephone: (213) 617-1200  
Facsimile: (213) 617-1975  
5  
6 Michael C. Spencer (*admitted pro hac vice*)  
mspencer@milberg.com  
7 Janine L. Pollack (*admitted pro hac vice*)  
jpollack@milberg.com  
8 **MILBERG LLP**  
One Pennsylvania Plaza  
New York NY 10119  
9 Telephone: (212) 594-5300  
Facsimile: (212) 868-1229  
10  
11

Eric M. George (SBN 166403)  
egeorge@bwgfirm.com  
**BROWNE WOODS GEORGE LLP**  
2121 Avenue of the Stars, Suite 2400  
Los Angeles, CA 90067  
Telephone: (310) 274-7100  
Facsimile: (310) 275-5697

Lee A. Weiss  
lweiss@bwgfirm.com  
**BROWNE WOODS GEORGE LLP**  
1 Liberty Plaza, Suite 2329  
New York, NY 10006  
Telephone: (212) 354-4901  
Facsimile: (212) 354-4904

(Additional Counsel on Signature Page)

12  
13  
14 *Attorneys for Plaintiff*  
15

16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF CALIFORNIA  
OAKLAND DIVISION

BRADLEY C. SMITH, derivatively on behalf of )  
FRANKLIN CUSTODIAN FUNDS, )

Plaintiff, )

vs. )

Civil Action No. C 09-4775 PJH

FRANKLIN/TEMPLETON DISTRIBUTORS, )  
INC., HARRIS J. ASHTON, ROBERT F. )  
CARLSON, SAM GINN, EDITH E. HOLIDAY, )  
FRANK W.T. LAHAYE, FRANK A. OLSON, )  
LARRY D. THOMPSON, JOHN B. WILSON, )  
CHARLES B. JOHNSON, AND RUPERT H. )  
JOHNSON, )

Defendants, )

and )

FRANKLIN CUSTODIAN FUNDS, )

Nominal Defendant. )

**PLAINTIFF'S OPPOSITION TO**  
**DEFENDANTS' MOTION TO DISMISS**  
**THE AMENDED COMPLAINT**

**TABLE OF CONTENTS**

	Page
PRELIMINARY STATEMENT .....	1
FACTS .....	6
A.    Recent Development: The SEC Proposes to Rescind Rule 12b-1 .....	6
B.    Relevant Facts.....	6
ARGUMENT.....	9
A.    The Amended Complaint Comports With Notice Pleading Requirements .....	9
B.    The Amended Complaint States a Cognizable Claim for Contract Voiding .....	10
1. <i>Transamerica</i> Is Binding Authority Holding That Contract Voiding is a Valid Cause of Action .....	10
2.    § 36(a) Is a Predicate Violation .....	14
3.    Rule 38a-1 Is a Predicate Violation .....	15
4.    Additional Allegations in Support of the ICA Predicate Violations.....	16
CONCLUSION.....	19

## TABLE OF AUTHORITIES

Page(s)	
3	<b>CASES</b>
4	<i>Alexander v. Sandoval</i> , 532 U.S. 275 (2001).....5
5	<i>Ante v. Office Depot Bus. Servs.</i> , 641 F. Supp. 2d 906 (N.D. Cal. 2009) .....10
6	<i>Bellikoff v. Eaton Vance Corp.</i> , 481 F.3d 110 (2d Cir. 2007).....10
7	<i>Berkeley Inv. Group Ltd. v. Colkitt</i> , 455 F.3d 195 (3d Cir. 2006).....12
8	<i>Continental Lab. Prods., Inc. v. Medax Int'l, Inc.</i> , No. 97-359, 1999 U.S. Dist. LEXIS 15383 (S.D. Cal. Aug. 12, 1999) .....11
9	<i>Davis v. Bailey</i> , No. 05-0042, 2005 U.S. Dist. LEXIS 38204 (D. Colo. Dec. 22, 2005) .....13
10	<i>Dreiling v. Am. Exp. Co.</i> , 458 F.3d 942 (9th Cir. 2006) .....8
11	<i>Dull v. Arch</i> , No. 05 C 140, 2005 U.S. Dist. LEXIS 14988 (N.D. Ill. July 27, 2005) .....13
12	<i>Everett v. Bozic</i> , No. 05-296, 2006 U.S. Dist. LEXIS 55824 (S.D.N.Y. Aug. 2, 2006) .....13
13	<i>Financial Planning Association v. SEC</i> , 482 F.3d 481 (D.C. Cir. 2007) ..... <i>passim</i>
14	<i>Flaxel v. Johnson</i> , 541 F. Supp. 2d 1127 (S.D. Cal. 2008).....12
15	<i>Hamilton v. Allen</i> , 396 F. Supp. 2d 545 (E.D. Pa. 2005) .....13, 14
16	<i>Jacobs v. Bremner</i> , 378 F. Supp. 2d 861 (N.D. Ill. 2005) .....13
17	<i>Kashani v. Tsann Kuen China Enterprise Co., Ltd</i> , 118 Cal. App. 4th 531 (2d App. Dist. 2004).....12
18	<i>Mutchka v. Harris</i> , 373 F. Supp. 2d 1021 (C.D. Cal. 2005) .....13

1	<i>Northstar Financial Advisors, Inc. v. Schwab Investments</i> , No. 09-16347, 2010 U.S. App. LEXIS 16706 (9th Cir. Aug. 12, 2010) .....	5, 14
2	<i>Olmsted v. Pruco Life Ins. Co.</i> , 283 F.3d 429 (2d Cir. 2002).....	11, 12
3		
4	<i>SEC v. Treadway</i> , 430 F. Supp. 2d 293 (S.D.N.Y. 2006).....	15
5		
6	<i>Smith v. Franklin/Templeton Distributors, Inc.</i> , No. C 09-4775, 2010 U.S. Dist. LEXIS 56516.....	<i>passim</i>
7		
8	<i>Stegall v. Ladner</i> , 394 F. Supp. 2d 358 (D. Mass. 2005) .....	13
9		
10	<i>Torsiello Capital Partners LLC v. Sunshine State Holding Corp.</i> , 600397/06, 2008 N.Y. Misc. LEXIS 2879 (N.Y. Sup. Ct. April 1, 2008), at *19.....	12
11		
12	<i>Transamerica Mortgage Advisors, Inc. v. Lewis</i> , 444 U.S. 11 (1979).....	<i>passim</i>
13		
14	<b>STATUTES</b>	
15	15 U.S.C. § 78cc(b).....	5, 11, 12
16	15 U.S.C. § 80b-2(11).....	17
17	15 U.S.C. § 80b-3(a).....	2, 17
18	Fed. R. Civ. P. 8(a)(2).....	9, 10
19	Fed. R. Civ. P. 8(a)(c)(1) .....	13
20		
21	17 C.F.R. § 270.6c-10(a)(i).....	6
22	17 C.F.R. § 270.12b-1(a)(2).....	7
23	17 C.F.R. § 275.202(a)(11)-1.....	18
24	<b>OTHER AUTHORITIES</b>	
25	Arthur B. Laby, <i>Reforming the Regulation of Broker-Dealers and Investment Advisers</i> ,” 65 Bus. Law. 395, 417 (Feb. 2010) .....	19
26		
27	<i>In re: O'Brien Partners, Inc.</i> , No. 7594, IA-1772, 1998 SEC LEXIS 2318 (Oct. 27, 1998) .....	17
28		

1	<i>In re: Quest Capital Strategies, Inc.,</i> 1999 SEC LEXIS 727 (Apr. 12, 1999).....	19
2	Restatement (Second) of Contracts § 178, comment.....	12
3	SEC Release, No. IA-1092, 1987 SEC LEXIS 3487 (October 8, 1987).....	17
4	SEC Release, No. IC-26299, 2003 SEC LEXIS 2980 (Dec. 17, 2003) .....	3, 16
5	SEC Release, Nos. 34-42099, IA-1845, 1999 SEC LEXIS 2356 (Nov. 4, 1999) (1999 Rule Proposal).....	8
6		
7		
8		
9		
10		
11		
12		
13		
14		
15		
16		
17		
18		
19		
20		
21		
22		
23		
24		
25		
26		
27		
28		

1 Plaintiff Bradley C. Smith, suing derivatively on behalf of Franklin Custodian Funds  
 2 (hereinafter the “Trust”), respectfully submits this opposition to Defendants’ Motion to Dsmiss the  
 3 Amended Complaint (“MTD”).

4 **PRELIMINARY STATEMENT**

5 The Court previously dismissed Plaintiff’s derivative claim on behalf of the Trust under §  
 6 47(b) of the Investment Company Act of 1940 (“ICA”), 15 U.S.C. § 80a-46(b), with leave to  
 7 amend, “[b]ecause the complaint alleges no violation of the ICA which can provide a predicate for  
 8 the claim under § 47(b)[.]” *Smith v. Franklin/Templeton Distributors, Inc.*, No. C 09-4775, 2010  
 9 U.S. Dist. LEXIS 56516, at \*\*23-24 (N.D. Cal. June 8, 2010) (“Smith”). Plaintiff’s Amended  
 10 Complaint cures each of the deficiencies identified by the Court by pleading substantial additional  
 11 facts in support of the predicate ICA violations that in turn establish a voidable contract and a cause  
 12 of action that may be maintained under § 47(b):

13 (a) With respect to the issue of whether payments by the Trust to the broker-dealers  
 14 pursuant to a Rule 12b-1 distribution plan are not “for services to customers” and are not “fees for  
 15 investment advice,” *see Smith*, at \*\*21-22, the Amended Complaint alleges that Rule 12b-1 fees are  
 16 predominantly used to compensate broker-dealers for providing investment advice to shareholders –  
 17 a fact that Defendants have admitted outside of the courtroom. *See* Amended Complaint (“AC”) ¶  
 18 55 (alleging that Franklin/Templeton Distributors prominently states on its own website that mutual  
 19 funds with Rule 12b-1 fees are designed for investors that “**prefer to ‘pay as they go’ for**  
 20 **professional investment advice**”).<sup>1</sup>

21 The Amended Complaint further alleges, consistent with Franklin/Templeton Distributors  
 22 admission, that the trade group that represents the interests of independent directors/trustees of  
 23 mutual funds, the Independent Directors Council (IDC), has issued a comprehensive industry study  
 24 showing that: “**Today, the overwhelmingly predominant use (98%) of 12b-1 fees is for**  
 25 **professional advice (initial and ongoing) and shareholder servicing. Only a small fraction**

27 <sup>1</sup> Citing [www.franklintempleton.com/retail/pages/generic\\_content/education/fund\\_basic/about/share\\_cl\\_options.jsf](http://www.franklintempleton.com/retail/pages/generic_content/education/fund_basic/about/share_cl_options.jsf). A copy is also attached to the Declaration of Janine Pollack (Pollack Decl.),  
 28 Ex. 1, submitted herewith.

1 (2%) of 12b-1 fees are used by funds for promotion, advertising and other miscellaneous  
 2 expenses.”<sup>2</sup> The IDC accordingly proposed in a comment letter to the SEC that Rule 12b-1 fees be  
 3 properly labeled -- calling them, in their words, a “third-party advice” fee. *Id.*; *see also* AC ¶ 57  
 4 (the mutual fund industry’s trade group, the Investment Company Institute (ICI), recommended to  
 5 the SEC that “12b-1 fees should be listed in the prospectus fee table using tailored,  
 6 straightforward, descriptive terms such as ‘third-party investment advice’[.]”).<sup>3</sup>

7 (b) With respect to the issue of whether the Trust may lawfully make asset-based  
 8 compensation payments to unregistered investment advisers, *see Smith*, at \*22, the Amended  
 9 Complaint identifies Section 203 of the Investment Advisers Act (the "Advisers Act" or the "IAA"),  
 10 which states that it is unlawful for any investment adviser that has not registered under the Advisers  
 11 Act “to make use of the mails or any means or instrumentality of interstate commerce in connection  
 12 with his or its business as an investment adviser.” AC ¶ 69; 15 U.S.C. § 80b-3(a). The receipt of  
 13 compensation constitutes the use of the means of interstate commerce. AC ¶ 69. The Amended  
 14 Complaint alleges that when the Trust and Franklin/Templeton Distributors make payments of  
 15 asset-based compensation to broker-dealers (other than broker-dealers that are dual registrants  
 16 holding Trust shares in advisory accounts), they are participating in, and using Trust assets for,  
 17 unlawful activity. AC ¶ 71. If the broker-dealer properly becomes a dual registrant and moves the  
 18 Trust shares into an advisory account, future violations would probably be avoided, but the past  
 19 violations would remain. AC ¶ 70.

20 (c) With respect to the issue of whether Plaintiff adequately pleaded a violation of ICA §  
 21 36(a), *Smith*, at \*24, the Amended Complaint alleges that the use of Trust assets to make illegal  
 22 compensation payments (*i.e.*, payments that violate § 203 of the Advisers Act) is a clear violation of  
 23

---

24 <sup>2</sup> AC ¶ 59, quoting IDC letter to SEC dated July 19, 2007, at 2 n. 3, available at  
 www.sec.gov/comments/4-538/4538-277.pdf.

25 <sup>3</sup> Defense counsel for the Trustees here, Goodwin Procter LLP, has also said that 12b-1 fees  
 26 compensate for investment advice. In a recent newspaper interview, a Goodwin Procter partner is  
 27 quoted as saying that broker-dealers “give advice on asset-allocation and performance,” and if Rule  
 28 12b-1 were to be rescinded by the SEC, “[l]imiting the amounts of money available to compensate  
 those advisers could have the unintended consequence of limiting the advice available to investors.”  
 See Pollack Decl., Ex. 2, submitted herewith.

1 the statutory fiduciary duty that governs the Trustees and Franklin/Templeton Distributors under the  
 2 ICA to use Trust assets properly. AC ¶¶ 72-75, 103-105.

3 (d) With respect to the issue of whether Plaintiff “has pled no facts identifying any defect  
 4 in the Rule 38a-1-related compliance policies and procedures of [the Trust],” *see Smith*, at \*21, the  
 5 Amended Complaint alleges that “checking each of its broker-dealer selling agents to make sure  
 6 they are registered and licensed under the Exchange Act, as applicable, but not checking to make  
 7 sure the firms are also registered and licensed under the Advisers Act, as applicable, is a material  
 8 defect” in the compliance policies and procedures of Franklin/Templeton Distributors, as approved  
 9 and overseen by the trustees of the Trust, because the “Advisers Act is no less of an important  
 10 federal securities law than the Exchange Act.” AC ¶ 80.

11 The Amended Complaint also quotes from the promulgating release for Rule 38a-1 stating  
 12 that “serious compliance issues must, of course, always be brought to the board’s attention  
 13 promptly, and cannot be delayed until an annual report.” AC ¶ 79 quoting Final Rule, Promulgating  
 14 Release No. IC-26299, 2003 SEC LEXIS 2980, at \*6 (Dec. 17, 2003). Accordingly, under Rule  
 15 38a-1, the Chief Compliance Officer of the Trust and the Trustees have a duty to act immediately if  
 16 Trust assets are being used improperly. *Id.*

17 (e) With respect to the issue of whether “the broker-dealers in the *Financial Planning* case”  
 18 received a different kind of asset-based compensation than the payments at issue here, *see Smith*, at  
 19 \*21, the Amended Complaint pleads evidence demonstrating that the package of services provided  
 20 to brokerage accounts (*i.e.* brokerage services and investment advice) and the form of compensation  
 21 received by the broker-dealer in connection with those customer accounts (*i.e.*, a set percentage of  
 22 assets held in the account that is paid by the investor and received by the broker-dealer) are identical  
 23 irrespective of whether the mutual fund company (as here) or the broker-dealer is processing the  
 24 asset-based compensation payments. *See* AC ¶ 50. In particular, documentation from Merrill  
 25 Lynch -- the broker-dealer firm that, prior to October 2007, maintained the largest number of  
 26 brokerage accounts in which the broker-dealer charged an asset-based fee -- explains that Merrill  
 27 Lynch’s asset-based fee arrangements “are simply pricing alternatives” to charging transactional  
 28 sales commissions, because the services provided to the account are the same as to any commission-

1 based brokerage account, and because the asset-based fees, like sales commissions, are not  
 2 specifically charged for investment advice. *Id.*<sup>4</sup>

3 (f) With respect to the issue of whether SEC Rule 202(a)(11)-1, the rule that was vacated by  
 4 *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007), is “irrelevant” to Rule 12b-  
 5 1 asset-based compensation payments, *see Smith*, at \*21, the Amended Complaint alleges that the  
 6 mutual fund industry thought the rule was relevant, and relied on it, prior to its being vacated: the  
 7 industry had celebrated the rule as a “clean solution” to the legality of Rule 12b-1 payments to  
 8 broker-dealers. AC ¶ 42. According to a client newsletter published in 1999 by the law firm of  
 9 WilmerHale (then Wilmer, Cutler & Pickering) for its mutual fund and broker-dealer clients,  
 10 “[i]nvestment companies have used asset-based fees under rule 12b-1 plans as compensation for  
 11 brokerage services, especially for the sale of so-called ‘B’ and ‘C’ shares,” and this form of  
 12 compensation could involve “special compensation,” but the SEC’s “proposed rule 202(a)(11)-1  
 13 would provide a clean solution to any questions about the applicability of the term ‘special  
 14 compensation’ by providing exemptions from the definitions of ‘investment adviser’ and ‘special  
 15 compensation’ for asset-based compensation[.]” *Id.*<sup>5</sup>

16 (g) With respect to the issue of whether there is an “absence” of rights-creating language in  
 17 § 47(b) creating a cause of action for contract voiding, *see Smith*, at \*20, Plaintiff cannot, of course,  
 18 alter this legal issue by amending the complaint. However, it is appropriate for the Court to  
 19 consider that the Supreme Court explicitly found rights-creating language in the parallel contract  
 20 voiding statutory provision in the Advisers Act – where the language and congressional intent was  
 21 substantively indistinguishable from that in the ICA. *See Transamerica Mortgage Advisors, Inc. v.*  
 22 *Lewis*, 444 U.S. 11, 19 (1979) (“we conclude that when Congress declared in [the contract voiding  
 23 statute] that certain contracts are void, *it intended that the customary legal incidents of voidness  
 24 would follow, including the availability of a suit for rescission or for an injunction against  
 25 continued operation of the contract, and for restitution.*” (emphasis added)).

26 <sup>4</sup> See Comment Letter to SEC by Merrill Lynch dated September 22, 2004, at 3 (available at  
 27 [www.sec.gov/rules/proposed/s72599/s72599-1191.pdf](http://www.sec.gov/rules/proposed/s72599/s72599-1191.pdf) ).

28 <sup>5</sup> A copy is also attached to the Pollack Declaration. *See Pollack Decl.*, Ex. 3.

1       The contract voiding statutes in the federal securities laws have always been construed *in*  
 2 *pari materia*, and *Transamerica* has been consistently followed, for contract voiding actions and as  
 3 a model approach to ascertaining “rights-creating language.” *See Alexander v. Sandoval*, 532 U.S.  
 4 275, 286, 290 (2001) (citing *Transamerica*); *Northstar Financial Advisors, Inc. v. Schwab*  
 5 *Investments*, No. 09-16347, 2010 U.S. App. LEXIS 16706, at \*27 (9th Cir. Aug. 12, 2010) (citing  
 6 *Transamerica*). *Transamerica* reflects the intent of Congress from the “rights-creating language” in  
 7 the contract voiding statute itself, and not as a judicially-created implied right of action.

8       Moreover, the Amended Complaint clarifies that the first cause of action is “an action  
 9 maintained in reliance upon Section 47(b).” AC ¶ 101. As discussed further below, this language is  
 10 identical to the language that Congress uses to refer to a private right of action for contract voiding  
 11 under the federal securities laws. AC ¶¶ 89-92 (the contract voiding provision in the Exchange Act,  
 12 Section 29(b), lists certain excepted predicate statutes and refers to “*in any action maintained in*  
 13 *reliance upon this subsection [Section 29(b)]*”). Accordingly, the intent of Congress to create a  
 14 *cause of action* cannot reasonably be disputed.

15       Defendants’ renewed motion to dismiss does not respond to or discuss any of these new  
 16 allegations in the Amended Complaint. *See* MTD at 5 (“No new facts of consequence have been  
 17 added by Plaintiff in the Amended Complaint[.]”). Instead, Defendants urge the Court to make  
 18 factual findings that directly contradict the facts alleged in the Amended Complaint. *See* MTD at 4,  
 19 5 n.1 (restating that Rule 12b-1 fees paid by the Trust are not “for services to customers” and not  
 20 “for investment advice” and these false facts are “law of the case”); AC ¶¶ 56-60. Plaintiff’s new  
 21 allegations cure the pleading deficiencies identified by the Court, as Defendants tacitly  
 22 acknowledge by simply refusing to acknowledge and address the new allegations in the Amended  
 23 Complaint.

24       A core purpose of the ICA is to ensure that mutual fund assets are not used for unlawful  
 25 purposes. Given that *Transamerica* dispository held that Congress intended to, and did, provide a  
 26 court forum to void contractual obligations that violate the ICA, Plaintiff respectively submits that  
 27 his derivative action on behalf of the Trust, maintained in reliance upon § 47(b), is cognizable, and  
 28 therefore the Motion to Dismiss should be denied.

## FACTS

## A. Recent Development: The SEC Proposes to Rescind Rule 12b-1

On July 21, 2010, the SEC released for public comment a proposal to rescind Rule 12b-1 in its entirety.<sup>6</sup> Under the proposal, Rule 12b-1 will be replaced by new rules that allow the use of fund assets to pay “transaction-based compensation”<sup>7</sup> to broker-dealers. The amount of any “deferred sales load” charged to fund investors can be no higher than the amount of the “reference load,” as defined in the new rules. The “reference load” is “a specified percentage of the net asset value of the offering price at the time of purchase[,]”<sup>8</sup> including any breakpoint discounts that the investor is entitled to receive.<sup>9</sup>

The Release refers to the pendency of this litigation, and also discloses that, beginning in 2007, numerous prominent experts have urged the SEC to address the Advisers Act violation that occurs when Rule 12b-1 fees are paid in the form of ongoing asset-based compensation to broker-dealers, in light of the *Financial Planning Association* decision.<sup>10</sup> In the Release, the SEC requests public comment on these issues and on whether its proposed new rules will “appropriately address” the Advisers Act issue “by requiring a nexus between the sale of a share of a mutual fund and the amount of ongoing sales charges an intermediary’s customer pays through the fund.”<sup>11</sup>

## B. Relevant Facts

Plaintiff Bradley C. Smith is invested in Class C shares of the Franklin Income Fund, a series of the Trust, and is therefore a shareholder in the Trust. AC ¶ 9. (The Franklin Income Fund

<sup>6</sup> See SEC Release Nos 33-9128, 34-62544, IC-29367 (July 21, 2010) (the “Release”), available at <http://www.sec.gov/rules/proposed/2010/33-9128.pdf> .

<sup>7</sup> *Id.* at 47 n. 168.

<sup>8</sup> *Id.* at 258; Proposed Rule 17 C.F.R. § 270.6c-10(a)(i).

<sup>9</sup> For instance, under the proposal, if an investor would have had to pay a 2% upfront sales load based on the sales load breakpoint discount schedule in effect for the fund family, then, as an alternative, the investor could be charged a deferred sales charge that cannot exceed 2% for one year, or 1% for two years, or 0.50% for four years, for example. *Id.* at 49.

<sup>10</sup> *Id.* at 125 n. 372.

11 *Id.* at 125.

1 is not a legal entity, is not an issuer of shares, and has no capacity to sue or be sued). Plaintiff's  
 2 shares in the Trust are held in a brokerage account at Merrill Lynch, Pierce, Fenner & Smith  
 3 Incorporated, AC ¶ 9, which provides traditional brokerage services, of which investment advice is  
 4 an auxiliary component. AC ¶ 23.

5 The Trust has elected to act as the distributor of its own shares. AC ¶ 65; *see* SEC Rule 12b-  
 6 1, 17 C.F.R. § 270.12b-1(a)(2) ("a company will be deemed to be acting as a distributor of  
 7 securities of which it is the issuer. . . if it engages directly or indirectly in financing [distribution  
 8 activities]"). The Trust is financing distribution activities, including the costs of distributing  
 9 prospectuses, and compensating broker-dealers for servicing shareholders, out of Trust assets, as  
 10 allowed by SEC Rule 12b-1. AC ¶ 61.

11 The current operative Distribution Agreement between the Trust and Franklin/Templeton  
 12 Distributors is dated February 8, 2008, and it contractually commits the Trust to pay certain  
 13 amounts specified in the Trust's Rule 12b-1 distribution plans to Franklin/Templeton Distributors  
 14 for disbursement to subcontracting retail broker/dealer firms, including payments as a percentage of  
 15 average daily net assets of Trust shares. AC ¶ 61.<sup>12</sup>

16 Franklin/Templeton Distributors allocates the payments to broker-dealers, broken down to  
 17 each customer account, calculated to the penny based on the daily net asset value of the respective  
 18 Trust shares held in each customer account. AC ¶ 62. These payments are ongoing, which means  
 19 that for each customer the payments continue to be made to the customer's broker-dealer for as long  
 20 as the customer owns Trust shares held in an account serviced by that broker-dealer. AC ¶ 62. The  
 21 payments are accrued daily and paid quarterly. AC ¶ 61.

22 The Trust began the practice of paying asset-based compensation to broker-dealers on May  
 23 1, 1995. AC ¶ 40; *see also* Pollack Decl., Exhibit 6 (excerpt from Franklin Custodian Funds  
 24

---

25 <sup>12</sup> According to the Trust's SEC filings, in addition to payments financed pursuant to Rule 12b-1  
 26 distribution plans, Franklin/Templeton Distributors makes ongoing "marketing support payments"  
 27 to broker-dealers based on daily net asset values of shares held in customer accounts. The Rule  
 28 12b-1 Plan payments and "marketing support payments" combined will be in excess of a rate of 1%  
 per year of average daily net assets for Class C shares of equity funds, in excess of 0.65% for Class  
 C shares of bond funds, and other rates for other share classes, and continue for as long as the shares  
 are owned. AC ¶ 61.

1 prospectus supplement effective May 1, 1995).<sup>13</sup> At the time, the SEC was encouraging broker-  
 2 dealers to shift away from transactional commissions, in favor of asset-based compensation  
 3 arrangements, a development that broker-dealers welcomed, at least so long as they did not have to  
 4 also provide customers with the enhanced investor protections of the Advisers Act. AC ¶¶ 38-40.

5 Prior to the 1990's, some mutual fund firms had issued share classes where Rule 12b-1 fees  
 6 were used to recoup the cost of paying upfront transactional commissions to broker-dealers. In  
 7 those arrangements, the broker-dealer received a one-time transactional commission payment. AC  
 8 ¶ 40.

9 Recognizing that the Advisers Act prohibits asset-based compensation in connection with  
 10 brokerage accounts, in 1999, the SEC formalized its support for asset-based compensation  
 11 arrangements by issuing a no-action position<sup>14</sup> and a proposed regulation, which eventually was  
 12 enacted in final form in April 2005,<sup>15</sup> that effectively suspended the statutory bar on asset-based  
 13 compensation. The final rule was immediately challenged in court by a trade group of registered  
 14 investment advisers and subsequently vacated as *ultra vires*. *See Financial Planning Association*,  
 15 482 F.3d at 488 (“**By seeking to exempt broker-dealers beyond those who receive only**  
 16 **brokerage commissions for investment advice, the SEC has promulgated a final rule that is in**  
 17 **direct conflict with both the statutory text and the Committee Reports.**”).

18 Following *Financial Planning Association*, over one million brokerage accounts holding in  
 19 excess of \$300 billion in assets in which asset-based compensation arrangements were in place were  
 20 converted by broker-dealers to advisory accounts or otherwise reformed to comply with the  
 21

---

22<sup>13</sup> On a motion to dismiss, the court may take judicial notice of SEC filings and other public  
 23 records. *Dreiling v. Am. Exp. Co.*, 458 F.3d 942, 946 n.2 (9th Cir. 2006).

24<sup>14</sup> The no-action position states that “the Division of Investment Management will not recommend,  
 25 based on the form of compensation received, that the Commission take any action against a broker-  
 26 dealer for failure to treat any account over which the broker-dealer does not exercise investment  
 27 discretion as subject to the [Advisers] Act.” *See Certain Broker-Dealers Deemed Not To Be*  
 28 *Investment Advisers*, Release Nos. 34-42099, IA-1845, 1999 SEC LEXIS 2356 at 5 (Nov. 4, 1999)  
 (1999 Rule Proposal). Industry interpreted the no-action position as retroactive, as the SEC  
 acknowledged in the release that asset-based compensation arrangements had begun earlier in the  
 decade.

29<sup>15</sup> 2005 Final Rule Release, 70 Fed. Reg. 20424 (April 19, 2005).

1 Advisers Act. AC ¶ 47. However, the Trust has continued with its asset-based compensation  
 2 arrangements without modification, allowing broker-dealers to easily evade the Advisers Act and  
 3 receive asset-based compensation in connection with brokerage accounts. AC ¶ 48.

4 Through his attorneys, Plaintiff made demand on the Board of Trustees by letter dated  
 5 January 8, 2009 to take corrective action, *see* AC ¶ 97; AC Exhibit 1, which was refused by letter  
 6 dated March 4, 2009, signed by counsel for the non-affiliated Trustees. *See* AC ¶ 98; AC Exhibit 2  
 7 (“The Board of Trustees has determined that the demands are not well-founded, as a matter of law,  
 8 and declines to take the steps, including litigation, that you propose.”).

9 In the absence of any substantive content in the response from the Board, Plaintiff’s counsel  
 10 continued their pre-suit investigation, and subsequently filed this shareholder derivative action on  
 11 behalf of the Trust on October 6, 2009. Service of process on the Trustees “was not completed until  
 12 December 18, 2009,” *see* MTD at 3, as this was the length of time that counsel to the Trustees  
 13 requested to coordinate consent to service, which Plaintiff provided as a courtesy. Defendants  
 14 moved to dismiss the original complaint, which the Court granted as to the first cause of action,  
 15 providing leave to amend “only the § 47(b) claim.” *Smith*, at \*23. Plaintiff filed an Amended  
 16 Complaint on July 7, 2010.

## 17 ARGUMENT

18 Defendants argue that the Amended Complaint contains too many legal conclusions and  
 19 fails to meet the notice pleading standard of Fed. R. Civ. P. 8(a)(2), and that contract voiding is  
 20 never a cognizable federal cause of action, and can only occur as a secondary remedy to a damages  
 21 cause of action. MTD at 6. Neither argument has any merit.

### 22 A. The Amended Complaint Comports With Notice Pleading Requirements

23 Under Fed. R. Civ. P. 8(a)(2), a pleading must contain “a short and plain statement of the  
 24 claim showing that the pleader is entitled to relief,” in order to “give the defendant fair notice of  
 25 what the . . . claim is and the grounds upon which it rests.” *Ante v. Office Depot Bus. Servs.*, 641 F.  
 26 Supp. 2d 906, 912 (N.D. Cal. 2009) (quoting *Mendiondo v. Centinela Hosp. Med. Ctr.*, 521 F.3d  
 27 1097, 1104 (9th Cir. 2008)). When a plaintiff’s complaint “outlines the ‘who, what, where, and  
 28 when’ of the alleged injury, it is hard to see how the complaint has not put defendant on ‘notice.’”

1 *Id.*

2 Defendants are on notice of the “who, what, where, and when” of the asset-based  
 3 compensation arrangements at issue in this case, and they do not contend otherwise. The source of  
 4 the duty of the Defendants to not use Trust assets for improper and unlawful purposes (§ 36(a) of  
 5 the ICA and Rule 38a-1 promulgated thereunder), and the injuries suffered by the Trust (depletion  
 6 of assets) and by its shareholders (who have been deprived of the advisory accounts they are  
 7 lawfully entitled to receive after paying ongoing relationship compensation), are clearly and plainly  
 8 alleged. AC ¶¶ 72-84, 103-107. Accordingly, the Amended Complaint comports with Fed. R. Civ.  
 9 P. 8(a)(2).

10 **B. The Amended Complaint States a Cognizable Claim for Contract  
 11 Voiding**

12 **1. *Transamerica* Is Binding Authority Holding That Contract  
 13 Voiding is a Valid Cause of Action**

14 “Congressional intent is the keystone as to whether a federal right of action exists for a  
 15 federal statute.” *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 116 (2d Cir. 2007), citing *Sandoval*,  
 16 532 U.S. at 286, which in turn is citing *Transamerica*, 444 U.S. at 15. The Supreme Court in  
 17 *Transamerica* found that Congress intended to establish a private right of action for rescission and  
 18 restitution for violations of the IAA, based on the text of the IAA’s contract voiding statute (§ 215),  
 19 while at the same time intending not to establish a private right of action for damages under any  
 20 section of the IAA. *Transamerica*, 444 U.S. at 19. The Supreme Court affirmed the plaintiff’s right  
 21 to bring a derivative action on behalf of the trust in that case for contract voiding and restitution for  
 22 the trust, arising from asserted violations of a predicate provision with no private right of action for  
 23 damages. *Id.* As the SEC has explained, after *Transamerica*, it is “beyond reasonable dispute that  
 24 private plaintiffs may seek rescission of a contract” under § 47(b), because the text of § 47(b) is  
 25 substantively indistinguishable from the text of § 215.<sup>16</sup> Defendants here tacitly concede that they

26 <sup>16</sup> See Brief of the SEC, Amicus Curiae, Submitted at the Court’s Request (Dec. 5, 2001) at Section  
 27 II, filed in *Olmsted v. Pruco Life Ins. Co.*, 283 F.3d 429 (2d Cir. 2002), available at  
 28 [www.sec.gov/litigation/briefs/olmsted.htm](http://www.sec.gov/litigation/briefs/olmsted.htm) (“SEC Amicus Brief”) (§ 47(b) of the ICA provides  
 distinct cause of action irrespective of whether predicate statute in the ICA alleged to be violated  
 contains any express or implied private right of action for damages). The court in *Olmsted* declined  
 to “consider the relevance of § 47(b)” to the plaintiffs’ claims in that case because “plaintiffs make

1 have no colorable basis to distinguish *Transamerica*, because their motion refuses to cite or discuss  
 2 it.<sup>17</sup>

3 Defendants' interpretation of § 47(b) guts the plain language of the provision. Through the  
 4 use of the language "any provision" of the ICA, and "any rule, regulation or order thereunder" to  
 5 describe the predicate laws for contract voiding, Congress in § 47(b) made plain its intent to include  
 6 all ICA provisions and regulations. Congress demonstrated, in the counterpart section of the  
 7 Exchange Act (§ 29(b)), that it knew how to exclude predicate provisions when it wished to do so.  
 8 See 15 U.S.C. § 78cc(b) (containing the same "any provisions" language, but then excluding a  
 9 predicate provision, and providing for a special statute of limitations period for two other predicate  
 10 provisions). None of the predicate provisions referred to has any private right of action for  
 11 damages.

12 Moreover, in connection with listing the predicate provisions subject to the special statute of  
 13 limitations in § 29(b), the statute states that "no contract shall be deemed to be void by reason of  
 14 this subsection *in any action maintained in reliance upon this subsection* [filed after the statute of  
 15 limitations period]," (emphasis added). That language plainly confirms that Congress intended the  
 16 contract voiding statute to be a *private right of action* for contract voiding.

17 Defendants' contrary argument -- that § 47(b) was intended only as a superfluous remedy  
 18 after the prosecution of a claim for damages – would actually mean that § 47(b) (and § 215 of the  
 19 IAA) were enacted as statutory nullities, because, as enacted in 1940, the ICA and IAA themselves  
 20 contained no private rights of action for damages.

21 Moreover, the plain language of § 47(b), as with each of the similar contract voiding statutes  
 22 in the securities laws, refers to *violations* of predicate provisions, not the prosecution of claims  
 23 under predicate provisions. See, e.g., *Berkeley Inv. Group Ltd. v. Colkitt*, 455 F.3d 195, 208 (3d

---

24 no claim under § 47(b), and because an issue raised only by an *amicus curiae* is normally not  
 25 considered on appeal." 283 F.3d at 436 n.5.

26 <sup>17</sup> By failing to cite controlling Supreme Court authority contrary to their legal position, to  
 27 distinguish it on the facts, or arguing that the precedent is no longer good law, or using some other  
 28 permissible form of advocacy, defendants are testing the limits of proper advocacy. See  
*Continental Lab. Prods., Inc. v. Medax Int'l, Inc.*, No. 97-359, 1999 U.S. Dist. LEXIS 15383, at \*55  
 (S.D. Cal. Aug. 12, 1999).

1 Cir. 2006) (“[an Exchange Act] Section 29(b) rescission claim premised on a Section 10(b)  
 2 violation, however, differs from a private damages action brought under *Section 10(b)*. In the  
 3 *Section 29(b)* context, a plaintiff seeking rescission does not have to establish reliance and  
 4 causation” because those are elements of a private right of action for damages, not elements of the  
 5 violation) (citing *GFL Advantage Fund, Ltd v. Colkitt*, 272 F.3d 189, 206 n.6 (3d Cir. 2001)).

6 In addition, § 47(b) also includes, in connection with contracts not yet performed, a future  
 7 tense, *i.e.* rescission due to performance that “would violate,” further establishing that no predicate  
 8 claim for damages is required. A party cannot prosecute a claim for damages when no violation has  
 9 yet occurred. Moreover, as a practical matter, a regulated party seeking to void an agreement that  
 10 violates, or will violate, *its own regulatory duties*, has no interest in suing itself for damages.

11 It is also important to observe that § 47(b) is “a version of the common law doctrine of ‘void  
 12 for illegality,’” *see* SEC Amicus Brief at Section II, and does not give anyone any rights they do not  
 13 already have under state law. *See, e.g., Kashani v. Tsann Kuen China Enterprise Co., Ltd*, 118 Cal.  
 14 App. 4th 531, 543 (2d App. Dist. 2004) (“a violation of federal law is a violation of law for  
 15 purposes of determining whether or not a contract is unenforceable as contrary to the public policy  
 16 of California”); *see also* Restatement (Second) of Contracts § 178, comment a (for purposes of the  
 17 void for illegality doctrine, the law is “any fixed text enacted by a body with authority to  
 18 promulgate rules, including not only statutes, but constitutions and local ordinances, as well as  
 19 administrative regulations issued pursuant to them.”).<sup>18</sup> As the Supreme Court noted in  
 20 *Transamerica*, it would be “anomalous” if the legality of contracts under federal laws and  
 21 regulations could only be litigated in state court. 444 U.S. at 19 n.8.

22 Finally, illegality is a recognized affirmative defense to a breach of contract claim. *See* Fed.  
 23 R. Civ. P. 8(a)(c)(1). As the Supreme Court noted in *Transamerica*, there is no substantive  
 24

---

25<sup>18</sup> Courts routinely void contracts in violation of federal statutes and regulations that have no private  
 26 rights of action. *See, e.g., Flaxel v. Johnson*, 541 F. Supp. 2d 1127, 1142 (S.D. Cal. 2008) (plaintiff  
 27 moved for summary judgment on claim for contract rescission due to violation of Regulation D  
 28 under the Exchange Act); *Torsiello Capital Partners LLC v. Sunshine State Holding Corp.*,  
 600397/06, 2008 N.Y. Misc. LEXIS 2879 (N.Y. Sup. Ct. April 1, 2008), at \*19 (“First  
 International’s failure to register as a securities broker [under the Exchange Act] also renders the  
 contract unenforceable under the common law doctrine of illegality.”).

1 difference between the defense of illegality and an affirmative action for contract voiding. 444 U.S.  
 2 at 18. If a mutual fund unilaterally stopped performing an illegal contract, and was sued for breach  
 3 of contract, would a court refuse to recognize the illegality defense until a counterclaim for damages  
 4 was prosecuted? Would the court strike the defense and order performance of the illegal contract?  
 5 A claim for contract voiding is merely the more civilized version of the illegality defense that is  
 6 already universally recognized.

7 In short, a plaintiff seeking to void a contract, whether directly or derivatively, is not acting  
 8 to “enforce” the law as a private attorney general, but rather is acting to *comply* with the law. The  
 9 district court cases on which Defendants rely<sup>19</sup> did not reach the issue of legal compliance, which is  
 10 the form of contract voiding recognized by *Transamerica*. Defendants’ cases all involved an  
 11 identical complaint filed by the same plaintiffs’ law firm<sup>20</sup> where the plaintiffs sought to invoke §  
 12 47(b) as a “remedy,” rather than as a cause of action, because the plaintiffs had no standing to  
 13 maintain a cause of action under § 47(b) -- as they were not parties to the contract between the  
 14 mutual fund and its manager sought to be rescinded.

15 The lack of standing is significant, because the plaintiffs in those cases were making a  
 16 frivolous argument, *i.e.* “Plaintiffs argue that because *Section 47(b)* ‘provides a remedy rather than a  
 17 distinct cause of action or basis for liability,’ there is no need for them to show independent  
 18 standing to pursue a claim under the section.” *Hamilton*, 396 F. Supp. 2d at 558. The courts simply  
 19 repeated plaintiffs’ theory, and correctly dismissed the § 47(b) claim, because the plaintiffs had no  
 20 viable claims under any other section of the ICA and, under that circumstance, essentially had  
 21 consented to a voluntary dismissal of the § 47(b) “remedy.”

22 <sup>19</sup> See *Dull v. Arch*, No. 05 C 140, 2005 U.S. Dist. LEXIS 14988 at \*8 (N.D. Ill. July 27, 2005);  
 23 *Hamilton v. Allen*, 396 F. Supp. 2d 545, 558 (E.D. Pa. 2005); *Mutchka v. Harris*, 373 F. Supp. 2d  
 24 1021, 1027 (C.D. Cal. 2005); *Stegall v. Ladner*, 394 F. Supp. 2d 358, 378 (D. Mass. 2005); *Davis v.  
 25 Bailey*, No. 05-0042, 2005 U.S. Dist. LEXIS 38204, at \*18-19 (D. Colo. Dec. 22, 2005); *Jacobs v.  
 26 Bremner*, 378 F. Supp. 2d 861, 869 (N.D. Ill. 2005).

27 <sup>20</sup> The suits each contended that a defendant mutual fund company had failed to participate in class  
 28 action settlements involving underlying securities held in the mutual funds. See *Everett v. Bozic*,  
 No. 05-296, 2006 U.S. Dist. LEXIS 55824, at \*3 (S.D.N.Y. Aug. 2, 2006) (another of “more than  
 40 virtually identical actions filed by Plaintiffs’ counsel against major U.S. mutual fund  
 companies”). In *Everett*, the court dismissed the Section 47(b) count for failure to plead as a  
 derivative action.

Without standing to void the contracts at issue, the plaintiffs in those cases were acting as private attorneys general. The courts in those cases were, therefore, correct in requiring that the plaintiffs needed a private right of action for damages. But the decisions cited by Defendants here do not purport to limit contract voiding when it is invoked by a party with standing, as evidenced by the fact that those courts had no occasion to consider *Transamerica*.

The Ninth Circuit's recent decision in *Northstar* (MTD at 7-8), finds no implied rights of action for damages in the ICA, and cites *Transamerica* as a model for the *correct* approach to finding rights-creating language in a statute. *Northstar*, 2010 U.S. App. LEXIS 16706, at \*27. The plaintiff in *Northstar* sought damages, and the court did not opine on illegality defenses, contract voiding, § 47(b) or any other issue relating to equitable relief in connection with compliance with the ICA. However, by citing to *Northstar*, which relies on *Transamerica*, Defendants appear to be conceding that *Transamerica* is relevant and applicable authority to analyzing the presence of rights-creating language in the ICA.

Accordingly, the Court should defer to Congressional intent, as found in *Transamerica*, and recognize Plaintiff's valid § 47(b) cause of action.<sup>21</sup>

## 2. § 36(a) Is a Predicate Violation

Plaintiff alleges that Defendants' violations of § 36(a) are a predicate violation to support a claim for contract voiding under § 47(b). AC ¶¶ 73-75, 104-107. Defendants disagree, contending that Plaintiffs have pled no facts alleging "breach of fiduciary duty involving **personal misconduct**" (emphasis by Defendants). MTD at 9, *citing Prescott v. Allstate Life Ins. Co.*, 341 F. Supp. 2d 1023, 1029 (N.D. Ill. 2004) (personal misconduct refers to misconduct that involves self-dealing). However, the Amended Complaint contains extensive allegations of self-dealing by Defendants. AC ¶ 74 & n.11, n.12 (Franklin/Templeton Distributors placed the pecuniary interests of its shareowner, Franklin Resources, Inc., which has an interest in maximizing sales and distribution to increase total assets upon which management fees are earned, ahead of the interests of the Trust and its shareholders in legal compliance and providing the advisory accounts that Trust

---

<sup>21</sup> If the Court finds no cause of action under § 47(b), Plaintiff respectfully requests that the Trust's § 47(b) claim be dismissed without prejudice to refilling a contract voiding claim under state law.

1 shareholders are paying for).

2 In any event, the majority view is that “the breaches of fiduciary duty Congress meant to  
 3 reach are not limited to those involving self-dealing, fraud, or conflicts of interest, given that  
 4 ‘nonfeasance of duty’ and ‘abdication of responsibility’ can also serve as violations of Section  
 5 36(a).” *SEC v. Treadway*, 430 F. Supp. 2d 293, 340-43 (S.D.N.Y. 2006) (citing cases).  
 6 Accordingly, under either standard, Plaintiff has adequately pled facts demonstrating a fiduciary  
 7 duty involving personal misconduct.

8 **3. Rule 38a-1 Is a Predicate Violation**

9 Without discussing the Amended Complaint, Defendants contend that the Amended  
 10 Complaint does not plead any facts identifying any defect in the Rule 38a-1-related compliance  
 11 programs of the Trust and its service providers. MTD at 10. However, the Amended Complaint  
 12 states that the Trust and Franklin/Templeton Distributors have a duty to use Trust assets properly,  
 13 and “checking each of its broker-dealer selling agents to make sure they are registered and licensed  
 14 under the Exchange Act, as applicable, but not checking to make sure the firms are also registered  
 15 and licensed under the Advisers Act, as applicable, is a material defect” because the “Advisers Act  
 16 is no less of an important federal securities law than the Exchange Act.” AC ¶ 80; *see also* In re  
 17 *Steadman Security Corp.*, 1983 SEC No-Act. LEXIS 2238 (Apr. 18, 1983) (improper use of mutual  
 18 fund assets will result in violation by trustees of § 36(a)).

19 Checking the licensing and registration status of the recipients of Trust assets is a function  
 20 performed by Franklin/Templeton Distributors, whose compliance program is subject to oversight  
 21 by the Trustees under Rule 38a-1. Therefore, plaintiff has adequately alleged, in the Amended  
 22 Complaint, that the Trustees have a duty under Rule 38a-1 to ensure that the Trust and  
 23 Franklin/Templeton Distributors not use Trust assets to make asset-based compensation payments  
 24 to firms that are not dual registrants offering advisory accounts.

25 For example, if the Trust decided to sell shares and service shareholders through pizza  
 26 parlors, Rule 12b-1 would allow the Trust to make compensation payments to pizza parlors, since  
 27 such a distribution plan clearly would promote distribution of Trust shares. However, the Rule 12b-  
 28 1 payments would violate the Exchange Act, and would also violate, depending on the form of

1 compensation paid, the IAA as well. In this example, the Trust is not responsible for overseeing the  
 2 compliance policies and procedures of pizza parlors. Rather, the Trust is responsible for not using  
 3 Trust assets to make unlawful payments, in violation of the Exchange Act and the IAA, to pizza  
 4 parlors.

5 Rule 38a-1 was enacted to clarify the fiduciary duty imposed by § 36(a), and the  
 6 promulgating release states that “serious compliance issues must, of course, always be brought to  
 7 the board’s attention promptly, and cannot be delayed until an annual report.” AC ¶ 79 *quoting*  
 8 Final Rule, Promulgating Release No. IC-26299, 2003 SEC LEXIS 2980, at \*6 (Dec. 17, 2003).  
 9 Accordingly, under Rule 38a-1, the Chief Compliance Officer of the Trust and the Trustees have a  
 10 duty to act immediately if Trust assets are being used improperly. *Id.*

#### 11           **4.       Additional Allegations in Support of the ICA Predicate Violations**

12       The Amended Complaint also alleges that “the customers of the broker-dealers who are  
 13 being deprived of the advisory accounts that they are entitled by law to receive are the same persons  
 14 who are the shareholders of the Trust to whom the Trustees and Franklin/Templeton Distributors  
 15 owe a fiduciary duty of care.” AC ¶ 82-84, 107-108. Accordingly, on the basis of their direct duty  
 16 to shareholders under § 36(a), Defendants are required to cease or reform the Trust’s asset-based  
 17 compensation arrangements until Trust shareholders are given the advisory accounts they have paid  
 18 for and are lawfully entitled to receive.

19       All of the allegations of breach of duty under the ICA are predicated on a finding that the  
 20 payments at issue are unlawful. The new allegations in the Amended Complaint plead that the  
 21 payments at issue are unlawful because the IAA states that the use of the means of interstate  
 22 commerce by unregistered investment advisors is unlawful. AC ¶ 69; 15 U.S.C. § 80b-3(a). In this  
 23 case, the Trust and Franklin/Templeton Distributors are using Trust assets to make compensation  
 24 payments to broker-dealers that, because of the form of compensation (asset-based compensation),  
 25 requires that the broker-dealers be dual registrants (registered under the Exchange Act and the  
 26 IAA), and hold Trust shares in advisory accounts. AC ¶¶ 22-46.

27       Previously, Defendants argued that the IAA was not implicated because the payments were  
 28 not for investment advice. The Amended Complaint shows that to be factually untrue, as

1 Defendants themselves have admitted outside of the courtroom, AC ¶¶ 51-60, 22-46, and in any  
 2 event, the subjective intent of parties to compensate for investment advice is legally irrelevant to the  
 3 applicability of the Advisers Act.

4 The definition of “investment adviser” is “**any person who, for compensation, engages in**  
 5 **the business of advising others. . . as to the value of securities or as to the advisability of**  
 6 **investing in, purchasing, or selling securities[.]**” 15 U.S.C. § 80b-2(11). The compensation  
 7 element is satisfied by *any economic benefit* received in connection with a customer account to  
 8 which investment advice is included in the package of services provided, including any third-party  
 9 payments. *See* SEC Release No. IA-1092, 1987 SEC LEXIS 3487, at \*14-15 (October 8, 1987)  
 10 (extensive discussion of the definition of investment adviser); *see also* *College Resource Network*,  
 11 1993 SEC No-Act. LEXIS 630 at \*4 (Apr. 9, 1993) (third-party payments are “compensation”); *In*  
 12 *re O’Brien Partners, Inc.*, Sec. Act Release No. 7594, IA-1772, 1998 SEC LEXIS 2318 at \*21, \*25  
 13 (Oct. 27, 1998) (there is no requirement that compensation be paid directly by the person receiving  
 14 the investment advice).

15 Accordingly, the label on the fee, the purpose of the fee, the intent of the fee, the form of the  
 16 fee, and the source of the fee are all legally irrelevant. If investment advice is part of the package of  
 17 services provided to an account, then any compensation received in connection with that account is  
 18 considered to be “compensation” for investment advice.<sup>22</sup> The only issue remaining is whether a  
 19 statutory exclusion applies.

20 Virtually all professionals who give investment advice do so as part of a package of services  
 21 (portfolio manager, brokerage, custodial and/or recordkeeping services, etc.) and their  
 22 compensation arrangements (commissions, management fees, etc.) rarely label their fees as  
 23 specifically for investment advice. Under Defendants’ version of the IAA, compliance with the  
 24 IAA would essentially be voluntary, based on the labels chosen for compensation payments.

25  
 26 <sup>22</sup> Similarly, a registered investment adviser that executes securities transactions must become a  
 27 dual registrant (*i.e.*, register as a broker-dealer), irrespective of whether the investment adviser is  
 28 receiving no compensation specifically for the transactions. *See PRA Sec. Advisors, L.P.*, 1993 SEC  
 No-Act. LEXIS 387 (Mar. 3, 1993) (investment adviser receiving only asset-based compensation  
 must nevertheless register as a broker-dealer if executing securities transactions).

1 Previously, after insisting that the IAA was “irrelevant” and not implicated by Rule 12b-1  
 2 payments, Defendants used the final minutes of the reply portion of their oral argument to contend  
 3 that the compensation payments at issue fell within the Broker-Dealer Exclusion to the IAA, which  
 4 necessarily means that the IAA is implicated and the payments need a statutory exclusion.<sup>23</sup> Yet,  
 5 Defendants’ interpretation of the Broker-Dealer Exclusion – *i.e.*, that broker-dealers can receive any  
 6 form of compensation so long as it is not specifically for investment advice – is identical to the SEC  
 7 Rule that was vacated in *Financial Planning Association* because it conflicted with the Broker-  
 8 Dealer Exclusion.<sup>24</sup> **See Financial Planning Association**, 482 F.3d at 488 (“**By seeking to exempt  
 9 broker-dealers beyond those who receive only brokerage commissions for investment advice,  
 10 the SEC has promulgated a final rule that is in direct conflict with both the statutory text and  
 11 the Committee Reports.**”).

12 The statutory text referred to by the *Financial Planning Association* court is the “no special  
 13 compensation” prong, and the Committee Reports constitute the legislative history establishing that  
 14 “special compensation” means any compensation not in the form of transactional commissions.<sup>25</sup>

15 <sup>23</sup> The general rule is that the party claiming the benefits of a statutory exclusion has the burden of  
 16 proving its applicability. *See United States v. First City Nat'l Bank*, 386 U.S. 361, 366 (1967). A  
 17 party cannot carry its burden of proof by making an argument -- for the first time on reply -- on a  
 motion to dismiss challenging the adequacy of plaintiff's pleading.

18 <sup>24</sup> The text of the invalidated Rule is, in pertinent part, that a broker-dealer “will not be deemed to  
 19 be an investment adviser based solely on its receipt of special compensation” provided that “[a]ny  
 20 investment advice provided by the broker or dealer with respect to accounts from which it receives  
 21 special compensation is solely incidental to the brokerage service provided to those accounts[.]”  
 22 The Rule goes on to codify several long-standing SEC interpretations of “solely incidental,”  
 23 including that “[a] broker or dealer provides advice that is not solely incidental. . . to the brokerage  
 24 services provided to accounts from which it receives special compensation within the meaning of  
 25 paragraph (a)(1)(i) of this section if the broker or dealer. . . charges a separate fee, or separately  
 26 contracts, for advisory services[.]” *See* 2005 Final Rule Release, 70 Fed. Reg. at 20454; 17 C.F.R.  
 27 § 275.202(a)(11)-1.

28 <sup>25</sup> *See* S. Rep. No. 76-1775, 76th Cong., 3d Sess. 22 (1940) (Section 202(a)(11)(C) of the Advisers  
 29 Act applies to broker-dealers “**insofar as their advice is merely incidental to brokerage  
 30 transactions for which they receive only brokerage commissions**”) (emphasis added). The SEC  
 31 has consistently found compensation other than transactional sales commissions to be “special  
 32 compensation.” *See Hugh Johnson & Co.*, 1976 SEC No-Act. LEXIS 420 (Feb. 22, 1976) (account  
 33 fee of 0.25% per year); *In re: Quest Capital Strategies, Inc.*, 1999 SEC LEXIS 727 at \*42 (Apr. 12,  
 34 1999) (retention of interest rate spread); *Calton & Assocs, Inc.*, 1988 SEC No-Act. LEXIS 1348  
 35 (Oct. 11, 1988) (2.5% per year of net asset value for market timing service); *CFS Securities Corp.*,  
 36 1987 SEC No-Act. LEXIS 1663 (Feb. 27, 1987) (fee of \$39 for customer to attend a seminar is  
 37 “special compensation” that disqualifies broker-dealer from invoking the broker-dealer exclusion to  
 38 the Advisers Act).

1 Defendants' interpretation of the Broker-Dealer Exclusion thus is identical to the invalidated  
 2 Rule, and therefore is also "in direct conflict with both the statutory text and the Committee  
 3 Reports." Defendants' interpretation would render the "no special compensation" prong of the  
 4 Broker-Dealer Exclusion superfluous. The "solely incidental" prong of the Broker-Dealer  
 5 Exclusion already prohibits broker-dealers from separately contracting to be paid for advice.<sup>26</sup>

6 Therefore, if there ever was, prior to *Financial Planning Association*, a sliver of doubt about  
 7 whether "special compensation" includes asset-based compensation, the law is now clear.<sup>27</sup>  
 8 Moreover, Congress subsequently declined to amend the Broker-Dealer Exclusion to remove the  
 9 ban on "special compensation," despite an aggressive lobbying campaign by industry in the months  
 10 following the *Financial Planning Association* decision.<sup>28</sup> Accordingly, there is *no colorable basis*,  
 11 in the wake of those developments, for Defendants to argue that broker-dealers may receive non-  
 12 transactional compensation in connection with brokerage accounts.<sup>29</sup>

13 **CONCLUSION**

14 For the reasons above, Defendants' motion to dismiss should be denied in its entirety.

15 Dated: September 17, 2010

**MILBERG LLP**

/s/ Janine L. Pollack

Janine L. Pollack (*admitted pro hac vice*)

17 Michael C. Spencer  
 18 mspencer@milberg.com  
 19 Janine L. Pollack  
 jpollack@milberg.com  
**MILBERG LLP**

20 <sup>26</sup> See also 2005 Final Rule Release, 70 Fed. Reg. at 20434 n. 103 (stating that although the final  
 21 Rule allows broker-dealers to receive any form of compensation, under the Rule, broker-dealers  
 22 may not receive compensation specifically for advice: "When the form of compensation  
 demonstrates that the advice is not solely incidental to brokerage, however, as in the case of  
 23 separate fees paid specifically for advice, the [Rule] will not be available.").

24 <sup>27</sup> See also Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*,  
 25 65 Bus. Law. 395, 417 (Feb. 2010) ("As a technical matter, the receipt of asset-based compensation  
 which vitiates application of the exclusion.").

26 <sup>28</sup> Burke, "The Hot Seat," *Registered Representative* at 44 (Sept. 2007) (Pollack Decl., Ex. 5).

27 <sup>29</sup> To the extent the Court reaches defendants' other arguments for dismissal, plaintiff respectfully  
 28 relies on the arguments made in his opposition brief filed February 12, 2010.

One Pennsylvania Plaza  
New York NY 10119  
Telephone: (212) 594-5300  
Facsimile: (212) 868-1229

Jeff S. Westerman (SBN 94559)  
jwesterman@milberg.com  
**MILBERG LLP**  
One California Plaza  
300 S. Grand Avenue, Suite 390  
Los Angeles, CA 90071  
Telephone: (213) 617-1200  
Facsimile: (213) 617-1975

Eric M. George (SBN 166403)  
egeorge@bwgfirm.com  
**BROWNE WOODS GEORGE LLP**  
2121 Avenue of the Stars  
Suite 2400  
Los Angeles, CA 90067  
Telephone: (310) 274-7100  
Facsimile: (310) 275-5697

Lee A. Weiss  
lweiss@bwgfirm.com  
**BROWNE WOODS GEORGE LLP**  
1 Liberty Plaza, Suite 2329  
New York, NY 10006  
Telephone: (212) 354-4901  
Facsimile: (212) 354-4904

Ronald A. Uitz  
ron877@yahoo.com  
**UITZ & ASSOCIATES**  
1629 K Street, N.W. Suite 300  
Washington, D.C. 20006  
Telephone: (202) 296-5280  
Facsimile: (202) 521-0619

Alfred G. Yates, Jr. Esq.  
yateslaw@aol.com  
**LAW OFFICE OF**  
**ALFRED G. YATES, JR. P.C.**  
519 Allegheny Building  
429 Forbes Avenue  
Pittsburgh, Pennsylvania 15219  
Telephone: (412) 391-5164  
Facsimile: (412) 471-1033

*Attorneys for Plaintiff*

## **CERTIFICATE OF SERVICE**

I hereby certify that on September 17, 2010, I electronically filed the foregoing with the Clerk of the Court by using the CM/ECF system.

Participants in the case who are registered CM/ECF users will be served by the CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage prepaid to the non-CM/ECF participants indicated on the attached Manual Notice List.

I certify under penalty of perjury that the foregoing is true and correct. Executed on  
September 17, 2010. 

~~Jason Joseph~~